IMPORTANCE OF FINANCIAL AUDIT IN LOWERING INFORMATIONAL RISK

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Abstract

The financial audit enables the credibility of the financial statements to be improved, from both accountants and financial information users' standpoints. This audit is required to provide information quality control. The article is intended to submit the causes involved in the occurrence of the informational risk as well as in the ways to lower risks.

Keywords: financial audit, financial information, informational risk, credibility.

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1. General framework

As the specialty literature quotes, the necessity of a financial audit is explained on account of three theories: motivation, agency and assurance.

1. Theory of motivation explains the need of auditing, attained by a high professional behaviour of those whose task is to work out the financial statements. Thus, the audit enhances the credibility of the financial statements but at the same time adds further information to the financial statements for motivational purposes; e.g. those who make out the financial statements will do a high quality work knowing aware the financial statements will be audited.

According to this theory the inaccuracy of some financial statements usually drawn up by the accountants, is discouraged because anyway these financial statements will be audited.

Consequently, this type of audit is quite necessary as it provides the control on the quality of information, thus:

- according to some pre-established criteria meeting the requirements and needs of the users of the accounting information, an independent control of the accounting information is provided;

- the audit is motivating the accountants to carry out a work in accordance with the user's criteria, the accountants knowing that their financial statements will be controlled by the auditor.

2. Theory of agency accounts for the necessity of implementing the audit because the investors can not trust fully the managers' proper use of the allocated funds thus excluding the possibility that the funds be embezzled to the managers' own benefit.

This theory is explained by the fact that:

- the owners and managers are distinct categories of users, each of them having in view the growth of their property;
- the managers tend to present the information given in the financial statements in such a way to win the owners' confidence, whereas the owners are not certain that the managers present the real facts;
- the information hold by the two groups of users are different, which makes each of them have the urge to gain an advantage over the other side.

These are the reasons why the owners need a nominated auditor to supervise the financial statements.

In their turn, the managers, as owners' employees, are interested in gaining the confidence of the owners, so either their income would diminish, or the owners would dismiss them. Therefore the managers also require an audit to put forward a positive opinion on the financial statements in view of having a better picture of the *business management* before the owners.

3. Theory of assurance explains the necessity of the financial audit on account of the following principles:

- the principle of assurance suggests that the auditor supply a certain degree of protection, to the persons relying on the information audited;
- the principle of information, providing that the information audited are more credible and useful to the main users (investors, managers, etc.) as for as the decision-making process is concerned.

There are requirements in the financial audit activity, as a result of:

- the conflict of interests among the accountants, entity and users of accounting information;
- the users of the financial information in the decision-making process;
- the fact that the users of the accountant information are not usually trained to assess the quality of the accounting information.

Thus, the auditor's opinion brings a higher credibility to the information audited, from the accountants' standpoint as well as from the standpoint of the users of the financial statements.

The auditor should supply a reasonable protection, based on an independent opinion about how the financial statements are true to facts, to the observance of principles, rules and to the criteria established in the recording and presentation of the accounting information. For this reason, the auditors are known as „the guardians" of the accurate financial statements published by the entities.

The financial audit is carried out on a well-defined standard basis. The right to put forward an opinion about the matter is reserved to the financial and statuary auditors as well as to the audit firms.

To have confidence in the information presented in the financial statements the external users need to have an audit of the financial statements.

Thus, for a better understanding of the need to have an audit, we will quote the following example:

When a bank manager has to make a decision about placing a loan to a company, he needs the auditing of the company's financial statements. His decision will be supported by:

- the former financial relations of the bank with the company;
- the financial position and the achievements of the company presented in the financial statements of the company mentioned.

In case the bank agrees upon the loan, the interest rate level will be defined by:

- the interest rate for the riskless placements which is quite equal with the interest rate the bank would obtain if it invested in state-owned bonds having the same date of payment as the loan applied for, by the company;
- the economic risk of the client, e.g. there is a risk for that the same company be not able to return the loan, because of some general or special economic condition caused by the enterprise activity, such as : economic recession, incorrect managerial decisions, unexpected competition in a certain activity field;
- informational risk reflecting the probability that the information underlying the assessment of the economic risk should be incorrect or the financial statements be erroneous.

An audit of the financial statements will result in the least informational risk, hence the bank manager will set a low level interest rate. At the same time the lowering of the informational level provides reasonable capital costs.

Let us say an enterprise applies for a bank loan of 100 mil. lei (Ron). If an audit of the financial statements costs 37.000 lei (Ron), the interest rate will drop by 1%, thus the interest cost savings will be 1 mil. lei (Ron) and the net savings will be 963.000 lei (Ron).

2. Causes of the informational risk

a. A great amount of information

The more the business grows, the higher the amount of the commercial transactions becomes. This causes a higher probability for the incorrectly registered information to be included in the balance sheet. As an example let us consider a company having a large number of suppliers and having paid an additional sum of 10.000 lei to one of the suppliers, apart from the overall debt; this because the error had not been found. The error was due to the fact that the company had not used some procedures to identify this type of error. When there are more than one unidentified error, the level of the combined errors can become significant.

b. Complex commercial transactions

A higher complexity of transactions results in their inappropriate recording: this prompts the need to use the professional reasoning.

c. Indirect access of users to information

It refers to the fact that the decision-making factors have no direct access to the information supplied by the entity. This information is supplied by other persons. All this may lead to a higher probability of misinformation, either intentionally or unintentionally.

d. Partiality and personal reasons of the information supplier

When the goals of the information supplier disagree with those of the decision-making factors, there is the risk that this information be manipulated, to the supplier's benefit. Thus, misinformation may occur. An entity can subject to a bank a financial statements containing erroneous information so that the chances to make a loan be greater.

This misinformation may acquire two forms:

- direct form – incorrect sums in the financial statements;
- indirect form – incomplete, improper financial statements.

3. Ways to cut down informational risk

As far as the informational risk is concerned, the companies have a different look upon this problem, depending on the extent of the problem. Small companies choose the most profitable alternative in that they prefer to pay higher interests rather than raise the expenses, thus cutting down the informational risk. This means employing auditors to perform the auditing of the financial statements. Large companies prefer to spend money to cut down the informational risk, by choosing one of the following ways:

➢ *auditing the financial statements*

The management employs an auditor who will assure the users that the financial statements comprise relatively complete accurate and impartial information. In case it is stated that the auditor's opinion is incorrect (financial statements are incorrect) the auditor can be sued by the users of the financial statements as well as by the managers who had employed the auditor;

➢ *informational risk of the entity's management taken by the user of financial statements*

The entity's managers have the responsibility to supply reliable information to users. In case users record a financial loss as they relied on incorrect financial statements, they can sue the management of the respective entity; cases when the losses can not be recovered are not few (e.g. entity's bankruptcy);

➢ *control of information by the user of financial statements*

The user can examine the financial statements of the respective entity to be certain of the correctness of the statements presented. Considering the cost of this procedure, it may be said that it is not quite efficient, however many users choose it.

The technologic and informational progress and the involvement of many entities in on-line activities will cause the audit value to grow, thus reducing the informational risk. Consequently the cost of attracting capital will go down.

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